Investments

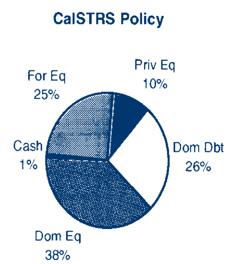
CalSTRS continues to follow its established long-term strategies. The results achieved this year and last year reaffirm the asset allocation decisions made by the Teachers' Retirement Board in 1997.

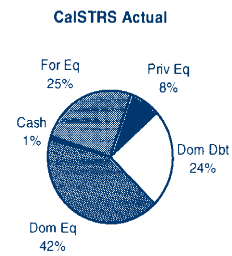
PENSION CONSULTING ALLIANCE, INC.

The CalSTRS investment portfolio grew by $12.7 billion over the past year reaching a value of $112.6 billion on June 30, 2000.[1] As highlighted below, the CalSTRS portfolio is broadly diversified, holding investments ranging from publicly-traded bonds to privately-held partnerships. Clearly, the scale and breadth of investments make the management and oversight of these assets highly complex. In light of these factors, CalSTRS has been effective in using its resources in a cost-efficient manner to ensure that benefits continue to flow to CalSTRS participants.

Investment Allocation

The most critical factor influencing overall investment performance is the allocation of the CalSTRS portfolio across major asset classes. The second quarter report reflects asset allocation guidelines adopted by CalSTRS on July 1, 1997 (see left pie chart). The portfolio's actual allocation is modestly different from policy. Private equity and domestic debt are underweighted while domestic equity is overweighted (see right pie chart).



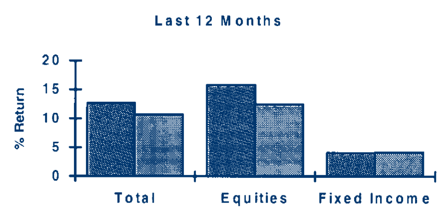


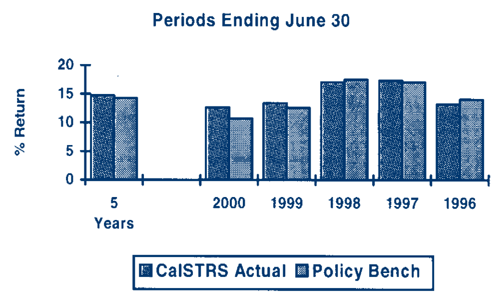
Investment Results

Over the last year, the CalSTRS investment portfolio produced an overall return of 12.7% ranking above-median among its large public pension fund peers[2]. The portfolio outperformed policy by approximately 2.0% largely due to strong relative performance within all asset classes, except domestic debt, where performance met expectations (top bar chart).[3]

During the last three years, CalSTRS' portfolio generated a 14.3% (second quartile) return versus 13.5% for the policy benchmark. Over the last five years, the CalSTRS investment portfolio produced an average annual return of 14.7%, exceeding its policy benchmark by 40 basis points (bottom chart). Successive one-year periods are shown as well. For periods ending June 30, CalSTRS' portfolio has outperformed its policy benchmark in three of the latest five one-year periods.

Recent performance has significantly improved CalSTRS' rankings among its peers over the three- and five-year periods.[4]





Pension Consulting Alliance, Inc.

[1] Per State Street Bank custodial accounting records as of 6/30/00.

[2] Per TUCS Universe for Public Funds with assets in excess of $1 billion.

[3] The policy benchmark consists of passively managed asset class portfolios weighted by CalSTRS' policy allocations. The difference between actual results and the benchmark are due to two factors: i) deviations from policy and ii) active decisions on the part of CalSTRS and its investment managers.

[4] CalSTRS' investment performance is calculated using a monthly internal rate of return and day-weighted cash flows. Periods longer than one month are geometrically linked. This method of return calculation complies with AIMR performance presentation standards.

The market value of the CalSTRS investment portfolio reached $112.6 billion on June 30, 2000. The $112.6 billion represented a gain of $12.7 billion over the same period last year. This dollar gain represented a return of nearly 13 percent, outperforming its benchmark by more than 200 basis points, adding more than $2 billion to the fund. Several asset classes exceeded their benchmarks, with exemplary performance shown by the Domestic and Private Equity segment. These strong results allowed CalSTRS' portfolio to finish in the 25th percentile in its peer group of large public funds. This marks the second consecutive period in which CalSTRS finished in the top quartile of Public Funds with assets in excess of $1 billion.

Last year, these pages remarked on how fully CalSTRS had participated in the market. This may be a good time to remind all that participation cuts both ways; at some point, the stellar gains that have been enjoyed in both the public equity and the private equity markets will revert to more traditional numbers. At the end of the last fiscal year, CalSTRS' portfolio allocation across asset classes was as follows: Equity—Domestic and International 67 percent; Fixed Income—Domestic 24.3 percent, Private Equity 7.9 percent. A small percentage was in cash, 0.8 percent.

CalSTRS continues to follow its established long-term strategies. The results achieved this year and last year reaffirm the asset allocation decisions made by the Teachers' Retirement Board in 1997.

Chart A, below illustrates the growth in the total investment portfolio, excluding securities lending collateral, from June 30, 1985 through June 30, 2000. Chart B shows CalSTRS' returns against the actuarial rate, which is the long-term assumed rate of return for the fund. Chart C shows the performance returns for all the asset classes in the portfolio and the benchmark indices. The return calculations are consistent with Association for Investment Management and Research performance presentation standards. These returns are shown over 1-, 3-, 5-, and 10-year periods.

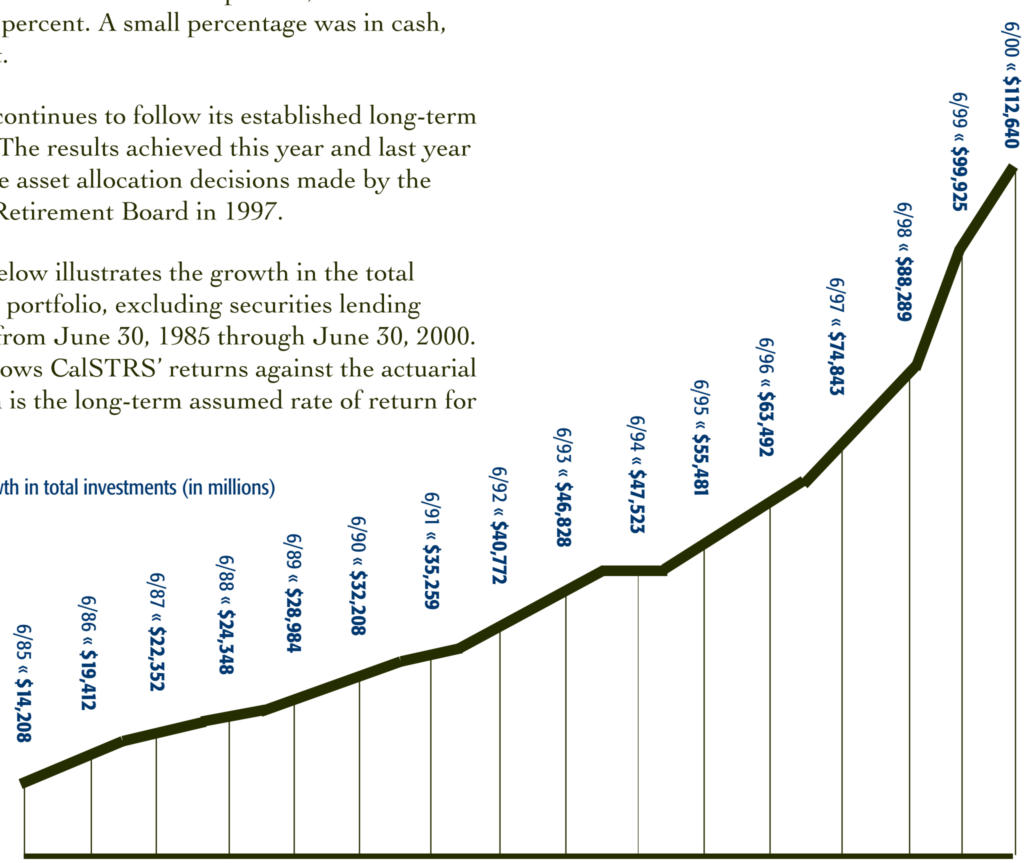
Objectives

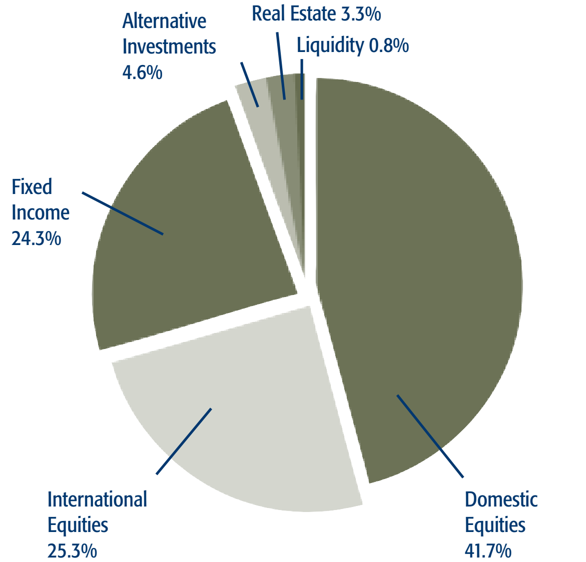
The objectives of the Investment Management Plan are the same as they were this time last year. This is the way it should be, since this is a perpetual, defined benefit plan. CalSTRS continued to be rewarded for the 1997 decision to increase the fund's exposure to active equity management; 11 of the 16 active equity managers outperformed their respective benchmarks. It is also noteworthy that even the larger, passive component exceeded the benchmark by 20 basis points. CalSTRS will continue to seek a close alignment between policy and actual allocations.

Fixed Income

The Fixed Income unit is responsible for the management of CalSTRS' fixed income assets, totaling approximately $27 billion in market value. As

Chart A Growth in total investments (in millions)





Asset allocation (6/30/00)
Total investment portfolio of $112.6 billion

of June 30, 2000, the Treasury/Agency portfolios represented a majority of the assets, with $10.7 billion. The High-Grade Corporate bond portfolio with $7.9 billion, and the Mortgage-Backed Securities portfolio with $8.3 billion in assets, respectively, completed the balance of the fixed income portfolio. For the fiscal year ending June 30, 2000, the long-term fixed income portfolios trailed the performance benchmark return by 10 basis points.

The Fixed Income unit also manages a short-term portfolio, known as the Liquidity Portfolio, which is utilized for cash and liquidity purposes. This portfolio

Chart B Growth in CalSTRS' returns (percent)

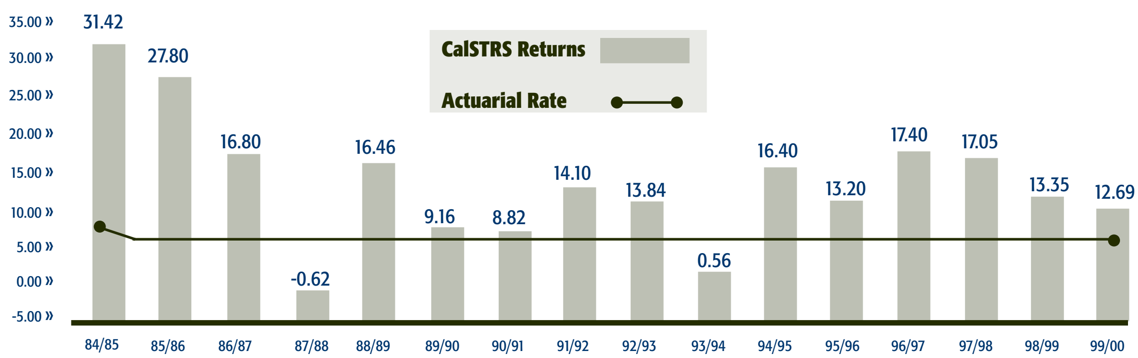


Chart C Performance returns for major asset categories

Portfolio Type/Associated Indices	1 Year	3 Years	5 Years	10 Years
Total Fund	**12.69**	**14.35**	**14.72**	**12.64**
Domestic Equity	**10.78**	**19.08**	**22.11**	**17.20**
Russell 3000	9.60	19.24	22.78	17.52
Wilshire 5000	9.52	19.06	22.47	17.28
Int'l Equity	**18.01**	**10.31**	**12.94**	**n/a**
MSCI All Country Free ex US (G)	18.10	9.46	11.12	8.28
MSCI Europe, Australia & Far East	17.16	10.18	11.32	7.95
MSCI Emerging Market Free	9.47	-4.96	0.99	8.94
Fixed Income	**4.13**	**6.75**	**6.64**	**8.75**
Salomon LPF	4.23	6.31	6.48	8.65
Real Estate	**9.13**	**16.53**	**14.27**	**6.04**
Real Estate Custom*	10.59	13.12	11.40	5.89
Alternative Investments	**78.60**	**41.66**	**37.27**	**23.13**
Alternative Investments Custom**	12.74	13.06	13.74	n/a
Liquidity	**6.32**	**6.14**	**6.07**	**5.80**
Salomon 3-Month Treasury Bill	5.31	5.08	5.19	4.93

(All performance calculations are conducted in accordance with the presentation standards of the Association for Investment Management and Research)
*NCREIF after 7/1/97 and Institutional Property Consultants prior to 7/1/97; lagged 1 quarter
**Blend of the [Russell 3000 + 5% + 90 day T-Bill] after 4/1/99 and [CPI + 12%] prior to 4/1/99; lagged 1 quarter

had approximately $896 million in assets at fiscal year end. While CalSTRS' goal is to be fully invested at all times, benefit payments and asset allocation decisions necessitate the need for short-term highly liquid assets that provide a competitive rate of return until re-deployed into other asset classes. The Liquidity Portfolio exceeded its performance benchmark return by 100 basis points for the fiscal year ending June 30, 2000.

The Fixed Income unit also manages three other programs: the Home Loan Program, the Currency Hedging Program and the Securities Lending Program.

Home Loan Program

Legislation, that became effective in 1999, broadened CalSTRS' ability to offer home loans with different interest rates, terms and conditions. During the last fiscal year, CalSTRS funded more than $55 million in home loans, bringing the total since origination in 1986 to nearly $3 billion. Correspondent lending firms participating in the program again increased, from 10 to 13. Consideration will be given to other firms as the year progresses.

Currency Hedging Program

The strategic objective for the five-year-old program is to reduce the risk of the passively managed segment of the international equity portfolio. CalSTRS currently hedges a portion of its international stock exposure in order to protect these assets against a strengthening U.S. dollar in both Asia and Europe. This program has been successful in adding value as a result of its prudent use of basic hedging principles and the strength of the U.S. dollar overseas. To date, the Currency Hedging Program has generated more than $450 million in additional income to the fund.

Securities Lending Program

CalSTRS has been lending securities since 1988; this represents CalSTRS' first and longest running "Off Balance Sheet Program." The program was designed to enable CalSTRS to use its existing asset base and investment expertise to generate additional income. The amount of income that is earned as a result of the Securities Lending Program is based on a number of factors. These factors include the types and amounts of stocks and bonds held by CalSTRS, the volume of securities loaned, the appetites of the financial markets for CalSTRS' inventory of securities and the reinvestment of the cash taken in as collateral. Over the last fiscal year, CalSTRS has earned more than $55 million from this activity; since inception, the program has earned approximately $350 million.

Alternative Investments

This fiscal year, CalSTRS made additional commitments of nearly $3 billion in this segment of the portfolio. Total commitments now amount to approximately $8.1 billion or 7 percent of the total portfolio. There are 100 partnerships and six co-investments in the alternative investment portfolio. At the end of the fiscal year, the total market value was $5 billion, representing nearly 5 percent of the total CalSTRS portfolio. CalSTRS continued to increase

Chart D Largest fixed income holdings as June 30, 2000 (CalSTRS maintains a complete list of portfolio holdings)

Issue	Maturity Date	Interest Rate	Par	Market Value	Average Cost	Unrealized Gain/(Loss)
US TREAS BDS	15-Aug-2017	8.88%	635,000,000	809,110,900	705,373,121	103,737,779
US TREAS BDS	15-Feb-2020	8.50%	535,000,000	670,922,100	648,057,426	22,864,674
US TREAS BDS	15-Aug-2019	8.13%	473,000,000	571,814,430	492,128,351	79,686,079
US TREAS BDS	15-Feb-2019	8.88%	420,000,000	540,552,600	456,607,679	83,944,921
US TREAS BDS	15-May-2017	8.75%	414,000,000	521,445,420	429,304,486	92,140,934
US TREAS BDS	15-Nov-2018	9.00%	355,000,000	460,999,450	445,375,805	15,623,645
FEDERAL HOME LN MTG CORP	29-Apr-2009	6.45%	485,000,000	451,956,950	467,296,274	(15,339,324)
FEDERAL HOME LN MTG CORP	15-Mar-2009	5.75%	480,500,000	437,629,790	432,072,145	5,557,645
US TREAS BDS	15-Nov-2016	7.50%	375,000,000	423,513,750	384,526,897	38,986,853
TENNESSEE VALLEY AUTH	15-Mar-2013	6.00%	415,000,000	384,393,750	429,952,337	(45,558,587)

Chart E Largest equity holdings as June 30, 2000 (CalSTRS maintains a complete list of portfolio holdings)

Issue	Shares	Market Value	Average Cost	Unrealized Gain/(Loss)
General Elec Co	28,948,341	1,534,262,073	339,400,465	1,194,861,608
Intel Corp	9,977,958	1,333,928,260	200,584,239	1,133,344,021
Cisco Sys Inc	20,509,828	1,303,655,947	217,027,755	1,086,628,192
Microsoft Corp	15,702,466	1,256,197,280	391,595,256	864,602,024
Pfizer Inc	18,667,157	896,023,536	242,378,526	653,645,010
Exxon Mobil Corp	10,065,497	790,141,515	360,501,884	429,639,630
Wal Mart Stores Inc	12,866,972	741,459,262	151,335,699	590,123,562
Oracle Corp	8,628,109	725,300,413	58,478,671	666,821,741
Nortel Networks Corp	9,210,606	628,623,860	135,589,273	493,034,587
Vodafone Airtouch	147,813,136	597,477,046	245,792,180	351,684,866

its commitment in this area as a result of the allocation review completed at the end of June 1997. The Alternative Investment asset class has achieved annualized returns of 79, 42 and 37 percent, for the 1-, 3- and 5-year periods, respectively.

Internal Equity Management

During 2000, CalSTRS increased the allocation to Internal Equity management by $7 billion. As of June 30, 2000, the internally managed S&P 500 indexed portfolio had a market value of $15.1 billion. This completes the allocation to this portfolio.

The performance objective of the internally managed passive portfolio is to track closely the return of the S&P 500 Index. During the period between June 1999 and June 2000, the Internal S&P 500 indexed portfolio returned 7.4 percent, slightly outperforming the benchmark S&P 500 Index return by 7.6 basis points.

Real Estate

Over the last fiscal year, CalSTRS portfolio of real estate assets reached $3.8 billion. Eighty-two directly owned properties and three privately owned partnerships represented this dollar amount. Real estate represents nearly 3 percent of the total portfolio. The direct property portfolio is diversified as to property type and geographic location. The largest component of the direct property sector is Office; as was true last year, the largest weighting is in the western region of the United States. The CalSTRS' Real Estate portfolio has achieved annualized returns of 9, 17 and 14 percent, for the 1-, 3- and 5-year periods, respectively.

Credit Enhancement

CalSTRS has entered into agreements with a number of issuers of non-taxable debt to provide the payment of principal and interest in the event of a non-payment. CalSTRS is paid on annual fee over the term of the agreement for each transaction. The majorities of the transactions are supported by collateral, letters-of-credit from banks or bond insurers for repayment. As of June 30, 2000, the Credit Enhancement program had commitments of approximately $1.1 billion and fee income earned over the year was more than $2 million.

External Equity Management

During 2000, the public equity portfolio continued to be an important investment vehicle for growth. In fiscal year 1999-2000, this segment of the portfolio accounted for about 67 percent (or $75.5 million) of the total fund. Domestic Equity accounted for 42 percent of the total equity allocation, while International Equity accounted for the remaining 25 percent. As was true last year, Domestic Equity was over-weighted relative to the policy target; the over-weighting is due to Private Equity allocations that are currently unfunded. The current policy mandates that unfunded allocations remain invested in Domestic Equity until needed. The policy is monitored on a continuing basis and as commitments are funded in Alternative Investments and Real Estate, these interim overweights are reduced. Pursuant to the policy mandates adopted in 1997 by the Teachers' Retirement Board, this protects the portfolio from veering away from the strategic asset allocation targets or taking unintentional "bets."

The CalSTRS portfolio results enabled the fund to finish in the 25th percentile of its peer group of large public funds. This is the second consecutive year that CalSTRS' results have placed it in the top quartile of its peers. Domestic Equity exceeded its benchmark by 120 basis points with a 10.8 percent return, while International Equity achieved an 18 percent return, slightly below its benchmark by 9 basis points. As an aside, for the first time, CalSTRS is reporting an international equity among its ten largest equity holdings as of June 30, 2000.

Corporate Governance

During the 1999-00 fiscal year, CalSTRS voted on a variety of proxy issues including financial, corporate governance and social issues. There were 7,192 votes cast on proxy issues of corporations whose shares were owned in the Investment Portfolio. These proxy issues were presented on 2,789 companies. The overall number of proxy issues increased from 6,588 last year, but the number of mergers/acquisitions reviewed remained constant, at a little more than 10 percent. Merger activity, both within United States borders and across the borders continued its steady course, especially in those transactions where stock is the compensation received by the acquired company's holders. This reflects the continued appreciation in the stock market, both at home and abroad.

Chart F Investment summary for the year ended June 30, 2000 (in millions)

	30-Jun-99		30-Jun-00			
Portfolio Type	**Book Value**	**Market Value**	**Book Value**	**Market Value**	**% of Market Value**	**Net Market Change**
Domestic Equity	20,996	45,838	22,477	46,982	41.71%	1,144
International Equity	19,021	23,686	21,922	28,546	25.34%	4,860
Fixed Income	24,880	24,902	27,694	27,312	24.25%	2,410
Alternative Investments	2,155	2,590	3,300	5,132	4.56%	2,542
Real Estate	2,360	2,170	3,943	3,772	3.35%	1,602
Liquidity	738	739	896	896	0.80%	157
Total Portfolio	70,150	99,925	80,232	112,640	100.00%	12,715
Plus: Securities Lending Collateral		15,516		16,107		
Less: Accruals		362		1,320		
Plan Net Assets–Investments		115,079		127,427		

Chart G Schedule of fees July 1, 1999 through June 30, 2000 (in thousands)

	Assets Under Management	**Fees**	**Basis Points**
Investment Managers' Fees:			
Domestic Equity	$46,982,198	$10,261	2.2
International Equity	28,563,905	31,673	11.1
Alternative Investments	5,131,705	1,163	2.3
Real Estate	3,771,560	12,844	34.1
Total Investment Managers' Fees	**$84,449,368**	**$55,941**	**6.6**

Chart H Broker commissions (July 1, 1998 through June 30, 2000)

Broker Name	Commission	Shares	Commission per share
Domestic Equity Transactions			
Jackson Partners + Associates Inc	427,150	7,487,683	0.057
Morgan Stanley And Co, Inc	361,921	9,480,937	0.038
Instinet	348,508	16,179,642	0.022
Investment Technology Group Inc.	336,637	12,871,102	0.026
Lehman Bros Inc.	272,466	6,559,035	0.042
Paine Webber Incorporated	254,705	4,608,893	0.055
Spear, Leeds & Kellogg	237,018	4,256,426	0.056
CS First Boston Corporation	222,199	6,457,425	0.034
Abel Noser Corporation	159,189	3,079,100	0.052
Capital Institutional Services	152,660	2,619,050	0.058
Other Domestic	2,049,792	42,885,693	0.048
Total Domestic	**4,822,245**	**116,484,986**	**0.041**
International Equity Transactions			
Morgan Stanley + Co	2,426,823	249,857,701	0.010
Merrill Lynch	1,538,734	620,525,714	0.002
Lehman Brothers Securities	923,194	401,485,507	0.002
CS First Boston Corp	744,209	71,632,057	0.010
Credit Lyonnais	505,279	71,022,096	0.007
HSBC Investment Bank PLC	492,302	19,474,107	0.025
Instinet	374,700	12,887,906	0.029
BHF Securities Corporation	334,834	8,224,489	0.041
Saloman Brothers Inc.	283,641	15,923,204	0.018
Deutsche Bank Securities Corp	251,876	9,370,058	0.027
Other International	3,118,649	1,240,317,333	0.003
Total International Commissions	**10,994,241**	**2,720,720,172**	**0.004**

The major issues voted are summarized below:

1. **Election of Directors:** CalSTRS generally votes in favor of directors unless the proxy statement shows circumstances contrary to policy. Examples of such circumstances are: greater than 50 percent board representation by company executives, potential conflict of interest due to other directorships or employment and classification of the company directors.

   Number Voted: 2,471
   For: 1,899
   Against: 572

2. **Selection of Auditors/Accountants:** CalSTRS generally votes in favor on the independent auditors and accountants recommended by management.

   Number Voted: 1,541
   For: 1,541
   Against: 0

3. **Compensation Plans:** (Stock Options, Incentive Stock Options, Employee Stock Purchase Plans, etc.) Corporations provide a variety of compensation plans to keep executives, employees and non-employee directors. A number of these plans provide for the issuance of long-term incentives to attract, reward, and retain key employees.Compensation Plans are evaluated based on CalSTRS' Financial Responsibility Criteria.

   Number Voted: 1,128
   For: 422
   Against: 706

4. **Approve Merger/Acquisition-Management:** CalSTRS generally votes in favor of the acquisition or merger of one company into another.

   Number Voted: 324
   For: 324
   Against: 0

5. **Corporate Actions/Corporate Governance Issues:** These are issues related to mergers, acquisitions, stock issuance, stock splits and incorporation. CalSTRS generally votes in favor of these proposals unless there is a compelling reason not to cast a positive vote.

   Number Voted: 555
   For: 181
   Against: 374

6. **Other-Miscellaneous–Management:** CalSTRS generally votes in favor of other miscellaneous business recommended by management, but issues are decided on a case-by-case basis.

   Number Voted: 612
   For: 338
   Against: 163

Cash Balance Benefit Program

The Cash Balance Benefit Program contributions are invested at the direction of the Teachers' Retirement Board in internally pooled portfolios of the Teachers' Retirement Fund. Sixty percent of the contributions are allocated to the S&P 500 portfolio and 40 percent to the Government Index portfolio. The CB Benefit Program has ownership of units of these pooled portfolios that reflect market fluctuations of underlying securities on a daily basis. Income and expenses are distributed to each pooled portfolio on a pro rata basis determined by the number of units owned as a percentage of the total units of the portfolio.

Contributions in the CB Benefit Program began on February 1, 1997. The investment value of those contributions as of June 30, 2000, is $10.6 million. For both portfolios, the combined total return for the past year was 6.8 percent. Since their inception, these portfolios have achieved a return of 17.4 percent. The benchmark returns for the past year were 7.3 percent for the S&P 500 and 5.5 percent for the Salomon Brothers Large Pension Fund –Treasury.